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# Family Trusts and Federal Taxes

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# FAMILY TRUSTS AND FEDERAL TAXES*

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SINCE the enactment of the federal income tax in 1913 and the federal estate tax in 1916, inter vivos private trusts have offered the major opportunities for minimization of tax burdens on family wealth. Under any long term plan, income and transfer taxes are reduced primarily by four means: by taking advantage of all statutory exemptions and deductions, by "splitting" to obtain lower brackets under progressive rates, by delaying and sometimes ultimately avoiding the realization of taxable gain, and by reducing the occasions for the imposition of tax. Inter vivos trusts of well recognized types, created for other purposes before 1913, have been used successfully for the past quarter century to reduce income and transfer taxes by three of these four basic means.[1] But for almost a decade there have been ominous signs in the sky, and in the past two years the scene has changed with startling speed. Uncertainties which always lay a trifle below the surface have emerged and various dangers are now too apparent to be ignored. The careful counselor or draftsman must not be content to study the statutory section seemingly in point on his particular problem and the most recent case in which it has been construed. Tax law has never been a static field. Both the statutes and their interpretation have always changed from year to year, and recently the interrelation of various sections in the statutes has received increasing notice from the courts. Wise counsel requires a panoramic view of the internal revenue code, with understanding of the relation of its parts and of the principles on which taxes are incurred or avoided, and a historic view of the development of statutory and case law with apparent trends projected into the future. With such an approach it may be difficult to offer "guaranteed tax saving plans," but at least illusory certainty can be avoided. Refraining from unsound advice is also part of the lawyer's task.

To obtain the essential perspective on trusts and taxes, one should look first at the two revenue measures chiefly involved and at the principles by which relief from their burdens may be obtained.

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[1] The fourth, delaying the realization of taxable gain, is usually obtained through incorporation.

Because the estate tax is levied upon a taxable event, the transfer through death of an owner's interest in property, it can be avoided by decreasing the number of occasions upon which property is transferred by death or by reducing the amount of property transferred on a particular occasion. Most simply, the estate tax can be avoided by transferring property by outright inter vivos gift from a present owner with a short life expectancy to an object of the owner's bounty whose life expectancy is longer. An outright gift from husband to wife will often have this effect. On a gift from a parent to his children the probability of an estate tax saving is very great. This use of the inter vivos gift has been limited, since the enactment of the Estate Tax Act in 1916, by the provision that gifts made or trusts created "in contemplation of death" must be included in the taxable estate of the donor. But the criteria of "contemplation of death" are so subjective[2] and the taxpayer's control over sources of evidence so great that this provision has never been highly effective.[3] However, it has been and still is the only statutory limitation on the reduction of estate taxes by absolute inter vivos gift.[4]

Why then should trusts be used at all to avoid estate taxes? What are the advantages of the inter vivos trust over the outright inter vivos gift? Principally they are two. In the first place, property can be so tied up in trust that no further transfers are required for two or more generations. If the owner of property gives part of it to his wife by absolute gift not in contemplation of death there will be no estate tax as to this property on the husband's death. The wife may die before the husband, however, and whenever she dies the property will be taxable in her estate unless she in turn has disposed of it in her lifetime. If she transfers it to her children, not in trust, there will be either a gift or an estate tax when they in turn transfer it to their successors. On the other hand, if the husband had put the property in trust for his wife for life, then for their children (naming them) for their lives, with distribution to the next generation twenty

[2] "It is apparent that there can be no precise delimitation of the transactions embraced within the conception of transfers in 'contemplation of death'. . . . . There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute." United States v. Wells, 283 U.S. 102, 119 (1931).

[3] See Mr. Justice Stone's dissent in Heiner v. Donnan, 285 U.S. 312, 332 (1932).

[4] The gift tax is a limitation on the reduction of estate taxes by inter vivos gift only in a very special sense. The gift tax rate is lower than the estate tax rate; it has a separate basic exemption and the amount given away in life does not affect the rate brackets applicable to the donor's estate on death. Hence it is still profitable in terms of transfer tax to give away more than half of a fortune during life.

years after the death of the last survivor of the children, all intermediate transfer taxes would have been avoided.[5]

Important though this advantage may be, another consideration probably has greater actual weight in most cases. Persons of wealth are naturally somewhat reluctant entirely to surrender the security and power which their wealth gives them and to turn their property over without restriction to younger and presumably less wise persons. The inter vivos trust affords a device by which the owner of property may dispose of it so far as tax liability is concerned while insuring that it will be used according to his wishes until the day of his death and beyond. In the words of Mr. Justice Cardozo, trusts may provide "a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels."[6] In addition there is at least the hope that some of the economic power and perhaps a little of the security can be retained by the donor for the rest of his life. It is primarily against this desire of the donor, the desire to have his cake and eat it too, that the specific trust provisions in the estate tax law are directed.

The original estate tax of 1916 included in the gross estate of decedent all property "to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for a fair consideration in money or money's worth."[7] In 1924, a second express limitation on the creation of tax avoiding trusts was added, including in the gross estate property "to the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke. . . . ."[8] On March 3, 1931, transfers by which the transferor disposes of future interests, retaining enjoyment for his own life, were expressly included within the gross estate for estate tax purposes.[9] Subject to clarifying amendments, this is the form of the estate tax today, including with property interests of the decedent at his death the subject of all gifts or trusts theretofore *a*) created or made in contemplation of death, *b*) taking effect in possession or enjoyment at or after death, *c*) revocable

[5] Treas. Reg. 80, art. 11.

[6] Burnet v. Wells, 289 U.S. 670, 681–82 (1933).

[7] 39 Stat. 777–78 (1917).

[8] 43 Stat. 304 (1925), 26 U.S.C.A. Int. Rev. Acts 67 (1940).

[9] 46 Stat. 1516 (1931), 26 U.S.C.A. Int. Rev. Acts 227 (1940).

or subject to alteration by the grantor alone or with others at the time of his death, or *d*) under which a life interest was reserved for the grantor.[10]

In the income tax field savings result from the use of trusts primarily by splitting incomes in order to reduce the maximum tax rates applicable to each portion. Under the present income tax laws, whenever one member of the family group has a very large income while that of other members of the group is substantially smaller, tax savings result from dividing the income more nearly equally, since the maximum surtax brackets applicable to the entire family income will thus be lowered. While earned income cannot be so divided,[11] there is no basis under the present statute and cases for questioning the effect of direct absolute transfers of income-producing property from a high-income to a low-income member of the group.[12] No trust is necessary to produce this saving. Under some circumstances, however, the tax saving can be accentuated by the creation of trusts. If the total family income is very high, even splitting it equally among all members of the group may still leave a large part subject to heavy rates. Moreover, if certain members of the group are children or young persons, it may be considered inexpedient for various reasons to give them equal shares in the whole. But since every trust is treated under the income tax laws as a distinct taxpayer,[13] it is theoretically possible indefinitely to multiply the number of "taxpayers" in the family unit. To the extent that the income of each trust is paid out to its beneficiaries no advantage results from the use of trusts as against direct gifts of capital.[14] But to the extent that income is accumulated in a large number of family trusts, the savings resulting from the use of these trusts may be far greater than could result from the direct gifts.[15] Moreover, here as under the estate tax, the natural desire of the settlor is to make an "Indian gift"[16]—to dispose of the income for tax purposes with the minimum

[10] Int. Rev. Code § 811(c), (d), 53 Stat. 121 (1939), 26 U.S.C.A. § 811(c), (d) (1940).

[11] Lucas v. Earl, 281 U.S. 111 (1930).

[12] Blair v. Com'r, 300 U.S. 5 (1937), distinguished but apparently approved in Helvering v. Horst, 311 U.S. 112 (1940).

[13] Int. Rev. Code §§ 161 et seq., 53 Stat. 66 (1939), 26 U.S.C.A. §§ 161 et seq. (1940).

[14] Int. Rev. Code § 162, 53 Stat. 66 (1939), 26 U.S.C.A. § 162 (1940).

[15] It is not clear how common such multiplication of trusts to accumulate is in actual practice. However, one case was brought out in the congressional hearings of the Joint Committee on Tax Evasion and Avoidance in 1937 in which 64 trusts had been created for the benefit of four members of an immediate family, Griswold, Cases on Federal Taxation 488 (1931); at a press conference on July 31, 1935, President Roosevelt spoke of one family which had divided its holdings among 197 separate family trusts, Ratner, American Taxation 471 (1942).

[16] Wales, Indian Gifts, 34 Ill. L. Rev. 119 (1939).

actual change of position. Under the income tax, as under the estate tax, the specific trust provisions of the act seem designed not to discourage tax avoidance by trusts under which the settlor effectively and completely cuts himself loose from the trust corpus, but merely to punish the Indian who gets too far off the reservation. Hence the law recognizes each distinct trust as a separate taxpayer, taxable on its accumulated income at the same rate as an actual person,[17] and provides for taxing the beneficiary on current income actually disbursed.[18] But it further provides for taxing the settlor on the income of trusts which are revocable by him[19] or the income of which is or may be distributed or accumulated for future distribution to him or the income from which may be used to pay premiums on his life insurance.[20]

Turning to the cases in which the trust provisions of the income and estate tax laws have been construed, we find two major periods which overlap to a considerable extent in time but which can nevertheless be distinguished. The first was the period in which Congress moved more or less aggressively to plug gaps in the law and the courts did no more (and occasionally less) than give effect to reasonably clear congressional intent. In the second period, the courts, particularly the United States Supreme Court, began actively to cooperate with the Treasury Department in carrying out the general scheme and purposes of the revenue code. In the last few years it may fairly be said that the Court is taking the lead in opposition to tax avoidance, being prepared in some cases to go further than Treasury counsel and the Department of Justice had apparently anticipated and considerably beyond anything that Congress has appeared explicitly to authorize.

Half a dozen leading cases were sufficient to sustain and largely to give effect to express congressional limitations on the use of trusts for the avoidance of taxes. In the early case of *Reinecke v. Northern Trust Co.*[21] trusts revocable at the will of the settlor alone were held subject to estate tax as "taking effect in possession or enjoyment at or after death" even before insertion in the law of a specific section applying the estate tax to revocable trusts. But in *May v. Heiner*,[22] confirmed in *Burnet v. Northern Trust Co.*,[23] the Court actually took a step backward. It held that the reservation of a life estate in a settlor, followed by vested remainders in

[17] Int. Rev. Code § 161(a), 53 Stat. 66 (1939), 26 U.S.C.A. § 161(a) (1940).

[18] Int. Rev. Code § 162(b), 53 Stat. 66 (1939), 26 U.S.C.A. § 162(b) (1940).

[19] Int. Rev. Code § 166, 53 Stat. 68 (1939), 26 U.S.C.A. § 166 (1940).

[20] Int. Rev. Code § 167, 53 Stat. 68 (1939), 26 U.S.C.A. § 167 (1940).

[21] 278 U.S. 339 (1929). [22] 281 U.S. 238 (1930). [23] 283 U.S. 782 (1931).

his children, did not result in a transfer taxable as one "taking effect in possession or enjoyment at or after death," although the contrary had very evidently been assumed in *Nichols v. Coolidge.*[24] The day after the decision in *Burnet v. Northern Trust Co.*, Congress amended the estate tax act by the joint resolution of March 3, 1931,[25] to provide expressly for the taxation at the death of the settlor of the corpus of a trust as to which the settlor had reserved the income or use for his own life. It was not until 1938 that a case reached the United States Supreme Court under this amendment when in *Helvering v. Bullard*[26] its validity was upheld. The Circuit Court of Appeals for the Seventh Circuit had held the joint resolution unconstitutional on the theory that because the transfer was inter vivos, was presently effective, was irrevocable, and was not made in contemplation of or intended to be effective at death, Congress was without power to make it the subject of an estate tax.[27] But the Supreme Court held, in an opinion by Mr. Justice Roberts, that "since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax."[28] Moreover, Congress, having the right to classify gifts of different sorts, might impose an excise at one rate upon a gift without reservation of a life estate and at another rate upon a gift with such reservation. Such a classification would not be arbitrary or unreasonable. Perhaps the Court's argument falls a little short of meeting the point in controversy, since the issue was not merely whether Congress might impose an excise at a special rate upon a gift with reservation of a life estate but whether this tax might properly be imposed upon the corpus of an inter vivos gift at its value on the death of the donor and with the rate dependent upon the amount of property owned by the donor at the time of his death. The second argument offered by Mr. Justice Roberts, that the legislative history of the joint resolution demonstrates that its purpose was to prevent avoidance of estate taxes and that the reservation of a life estate is a means commonly used for such tax avoidance, more satisfactorily explains the result.

In *Corliss v. Bowers*[29] the Court upheld Section 219(g) of the Revenue Act of 1924 specifically including the income of a revocable trust in the taxable income of its settlor. In accordance with the precise language of what was then Section 301(a) of the Revenue Act of 1926, the estate of the

[24] 274 U.S. 531 (1927).

[25] 46 Stat. 1516 (1931), 26 U.S.C.A. Int. Rev. Acts 227 (1940).

[26] 303 U.S. 297 (1938).

[27] Bullard v. Com'r, 90 F. (2d) 144 (C.C.A. 7th 1937).

[28] Helvering v. Bullard, 303 U.S. 297, 301 (1938).

[29] 281 U.S. 376 (1930).

settlor was held in *Porter v. Com'r*[30] to be taxable upon the corpus of a trust not strictly revocable but as to which the settlor had retained the right to amend in various matters, even to the extent of taking property from the beneficiaries named and transferring it to others, but without the right to regain the beneficial interest in the property himself. The Court, in the unanimous opinion by Mr. Justice Butler, found that the degree of control here retained by the settlor was sufficiently great to justify Congress in treating the property as still his for estate tax purposes. In *Helvering v. City Bank Farmers Trust Co.*[31] the Court took its last step in literal acceptance of the statutory provisions applying the estate tax to the corpus of revocable trusts. In this case the Court gave literal effect to the provision of Section 302(d) of the Revenue Act of 1926, which included in the gross estate of the decedent any interest in property of which he had at any time made a transfer where its enjoyment was subject at the date of his death to any change through the exercise of a power "either by the decedent alone or in conjunction with any other person to alter, amend or revoke"; so that a trust was included for estate tax purposes, although the decedent's power to revoke or amend had been subject to the approval of one of the beneficiaries of the trust. This result was somewhat of a surprise to the bar at the time because the parallel provision of the income tax law limited the inclusion of trust income in the gross income of the settlor to situations in which the trust was revocable by the settlor alone or in conjunction with any person "not having a substantial adverse interest therein."

The statutory provisions in cases discussed thus far operate on a more or less consistent theory. Where property is placed in trust without strings so that the grantor surrenders its immediate benefit, the hope of recovering it, and control over its use and disposition, income from that property is no longer income of the grantor and the property itself is not property of the grantor so as to be subject to transfer tax on his death. Where, however, the grantor has retained the right to recover the property itself, or its income, or effective control over its enjoyment, the whole transfer may not be effective to save either income or estate tax. There were minor variations in the operation of the two taxes but the principle was fairly clear.

Even the much discussed case of *Helvering v. Hallock*[32] is no more than a special and perhaps extreme application of these doctrines. In the *Hallock* case it was held that transfers under which the grantor retained until his death a possibility of reacquiring the corpus of the gift (whether this possi-

[30] 288 U.S. 436 (1933). [31] 296 U.S. 85 (1935). [32] 309 U.S. 109 (1940).

bility should technically be described in terms of property law as a possibility of reverter, a reversion, a remainder, or a mugwump) left the property so transferred subject to tax in the estate of the grantor under Section 811(c) of the Internal Revenue Code. While this decision may have disclosed an extraordinary willingness on the part of the Court to disregard its own earlier decisions, it may still be regarded as operating on the Indian gift principle, and, if a matter of first impression, would have been a perfectly reasonable and perhaps the preferable construction of the statutory language involved.

But some time earlier, other lines of cases foreshadowed a quite different approach to the taxability of trusts, an approach the ultimate consequences of which are still difficult to evaluate. The first of these extremely significant cases is *Burnet v. Wells*.[33] In 1924 Congress had added to the income tax law what is now Section 167(a)(3) of the code, providing that where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor, such part of the income of the trust shall be included in the gross income of the grantor. One Frederick B. Wells had created trusts in 1922 which were irrevocable and were for the purpose of paying the premiums on policies of insurance on the life of the grantor. The policies of insurance themselves had been transferred to the trusts and the settlor had no power of disposition over them. The majority of the Court upheld the statute as applied to this case. "The meaning of the statute is not doubtful, whatever may be said of its validity," the Court stated.[34] Then followed a rather long opinion by Mr. Justice Cardozo arriving at the conclusion that the statute was valid as well as clear. The case has been so frequently cited and in so many connections that careful rereading of the entire opinion is strongly advised. The following excerpts seem particularly significant:

> Insurance for dependents is today in the thought of many a pressing social duty. Even if not a duty, it is a common item in the family budget, kept up very often at the cost of painful sacrifice, and abandoned only under dire compulsion. It will be a vain effort at persuasion to argue to the average man that a trust created by a father to pay premiums on life policies for the use of sons and daughters is not a benefit to the one who will have to pay the premiums if the policies are not to lapse. Only by closing our minds to common modes of thought, to every-day realities, shall we find it in our power to form another judgment.....
>
> Trusts for the preservation of policies of insurance involve a continuing exercise by the settlor of a power to direct the application of the income along predetermined channels. In this they are to be distinguished from trusts where the income of a fund, though payable to wife or kin, may be expended by the beneficiaries without restraint,

[33] 289 U.S. 670 (1933).

[34] Ibid., at 675.

may be given away or squandered, the founder of the trust doing nothing to impose his will upon the use. There is no occasion at this time to mark the applicable principle for those and other cases. . . . .[35]

It is certainly worth noting that the application of income along predetermined channels is no more a feature of insurance trusts than it is of trusts providing for accumulation. The situation distinguished by Mr. Justice Cardozo was that in which the income is payable to wife or kin and may be expended by them without restraint; in other words, the situation in which the income is taxable under present law to the beneficiary. The distinction between the trust in the *Wells* case and the ordinary trust for accumulation must lie merely in the express language of the statute.[36] And since in this case the settlor had no control whatsoever over the trusts or over the policies of insurance upon which premiums were to be paid by the trust, the Indian gift theory in its ordinary form was not applicable. The possible implications of this case were obviously enormous and became the subject of immediate discussion. But it was some time before they bore fruit.

The next occasion on which the Court took a considerable step in what proved to be the new direction, there was no specific statutory provision, but a much tighter legal argument was available even under the Indian gift theory of trust taxation. This was the case of *Douglas v. Willcuts*,[37] in which the Court held that the income of a trust entered into to pay alimony to the settlor's divorced wife was taxable to the settlor. After noting that under the law of the state in which the divorce took place a lump sum settlement did not operate and could not operate to deprive the divorce court of its continuing jurisdiction to award alimony and that under the precedents in the United States Supreme Court amounts paid to a divorced wife under an alimony decree were regarded as income to the husband but not as income to the wife, the Court concluded that the situation here was one under which payments were made to discharge a legal obligation of the husband and were in effect income to the husband. The Court said in part:

The creation of a trust by the taxpayer as the channel for the application of the income to the discharge of his obligation leaves the nature of the transaction unaltered. *Burnet* v. *Wells*, *supra*. In the present case, the net income of the trust fund, which was

[35] Ibid., at 681–82.

[36] While there may be situations in which the retention of insurance on the life of the breadwinner is "a pressing social duty," such was hardly the case with Frederick B. Wells, who had an income of around $150,000 a year and could fund an insurance trust to meet annual premiums of about $17,000. Frederick B. Wells, 19 B.T.A. 1213 (1930).

[37] 296 U.S. 1 (1935).

paid to the wife under the decree, stands substantially on the same footing as though he had received the income personally and had been required by the decree to make the payment directly.

We do not regard the provisions of the statutes as to the taxation of trusts, fiduciaries and beneficiaries (Revenue Acts, 1926, §§ 2, 219; 1928, §§ 161, 162), as intended to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him. These provisions have appropriate reference to cases where the income of the trust is no longer to be regarded as that of the settlor, and we find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it.[38]

The second of these paragraphs in retrospect seems particularly significant.

This case, read with *Burnet v. Wells*, looked as though it might be the opening wedge of an extremely broad doctrine operating to destroy the income advantages of most private trusts. However, the principle of *Douglas v. Willcuts* has been restricted fairly closely to cases of trust income used to meet legally enforceable, though not necessarily liquidated, obligations of the settlor.[39] In the recent cases of *Helvering v. Fuller*[40] and *Helvering v. Leonard*[41] the divorced husband's continuing obligation for support has been made the test of taxability of alimony trusts, so that where the establishment of the trust completely and permanently discharges the obligation of the divorced husband the income from the trust is no longer taxable to the grantor but is taxable to the divorced wife.[42] The Circuit Court of Appeals for the Third Circuit recently held, in *Com'r v. Mesta*,[43] that the husband's transfer of assets in a lump-sum alimony settlement is in effect a sale or exchange of these assets in consideration of the surrender of the wife's right of support so that on such a transfer a capital gain may be realized.

If the cases described above were straws in the wind, the decisions of the United States Supreme Court last year in *Helvering v. Clifford*,[44] *Helvering v. Horst*,[45] and *Helvering v. Eubank*[46] are storm warnings. The *Clifford* case involved the controversy which the Treasury Department had been push-

[38] Ibid., at 9–10.

[39] E.g., Schweitzer v. Com'r, 75 F. (2d) 702 (C.C.A. 7th 1935), rev'd per curiam sub nom. Helvering v. Schweitzer, 396 U.S. 551 (1935).

[40] 310 U.S. 69 (1940).

[41] 310 U.S. 80 (1940).

[42] Pearce v. Com'r, 62 S.Ct. 754 (1942).

[43] 123 F. (2d) 986 (C.C.A. 3d 1941), noted in 9 Univ. Chi. L. Rev. 525 (1942).

[44] 309 U.S. 331 (1940).

[45] 311 U.S. 112 (1941).

[46] 311 U.S. 122 (1941).

ing for a number of years concerning the income tax status of the short term trust. Although the income tax law provides that the grantor may be taxed on the income of a trust where he retains the power to revest in himself title to any part of the corpus, this language is not directly applicable to a trust entirely irrevocable but so drawn that by its own terms it will end after a rather short period of time, where the property will return to the grantor but not by reason of any power retained by him. The courts have consistently held, up to and including the case of *Helvering v. Wood*,[47] that the statutory language of Sections 166 and 167 does not cover short term trusts and the Treasury Department had tried without success to obtain a new clause specifically taxing such trusts. In the *Clifford* case, however, Government counsel offered a different argument. They contended that irrespective of any language or significant lack of language in the sections dealing expressly with trusts, Section 22, which merely defines gross income, was sufficiently broad to include in the income of a settlor the income of a trust which under the circumstances might be regarded as too nearly illusory to justify tax recognition. In the *Clifford* case the trust by its terms was to expire in five years. The settlor was himself the trustee and reserved all powers of management and control. The sole beneficiary was the settlor's wife. It was not contended that tax savings were the sole consideration involved in the settlor's decision to set up this trust, that there was any restriction placed on the beneficiary's use of the trust income, or that the trust was designed to relieve the taxpayer from liability for family or household expenses. Nevertheless, the income was held taxable to the settlor. Mr. Justice Douglas, speaking for the Court, said in part:

> In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trusts, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of § 22(a).
>
> So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income

[47] 309 U.S. 344 (1940).

remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered. But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive § 22(a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before. Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of § 22(a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.[48]

Then, after stating that the mere existence of Sections 166 and 167[49] did not operate to exclude this trust from the more general language of Section 22, the Court said:

In view of this result we need not examine the contention that the trust device falls within the rule of *Lucas* v. *Earl*, 281 U.S. 111, and *Burnet* v. *Leininger*, 285 U.S. 136, relating to the assignment of future income; or that respondent is liable under § 166, taxing grantors on the income of revocable trusts.[50]

The result of this case has been criticized on two grounds. It certainly constituted a bold stroke of legislation, which some do not consider the proper function of the Court. The existence in the statute of specific and detailed provisions for the taxation of trusts, coupled with the failure of Congress on request to add to those provisions another which would cover

[48] Helvering v. Clifford, 309 U.S. 331, 335–37 (1940).

[49] Section 161(b), which provides that "the tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary, except as provided in § 166 (relating to revocable trusts) and § 167 (relating to income for benefit of the grantor)," was not mentioned by the Court.

[50] Helvering v. Clifford, 309 U.S. 331, 338 (1940).

this situation, must make it reasonably clear that the "broad and sweeping language of Section 22(a)" was not regarded by the legislature as applicable to such a situation as this. Moreover the result of this case was to leave the situation for the future extremely obscure. In the majority of all private trusts you will find at least one of the three factors relied upon by Mr. Justice Douglas and in many of them you will find two. By carefully refraining from indicating on what factor he placed his primary reliance and as well by the somewhat obscure suggestion that the trust device generally may fall within the rule of *Lucas v. Earl*,[51] the Court, evidently intentionally, broadened the area of uncertainty in the taxability of trusts.[52]

*Helvering v. Horst*[53] and *Helvering v. Eubank*[54] made a further substantial contribution to uncertainty in this field. In the *Horst* case the owner of bonds clipped coupons shortly before they were due and gave these coupons to his son. The Court held that the coupons when paid were income to the father as owner of the bonds. The father's position in the case appeared technically impregnable. He had disposed of his severable property right in the coupons before payment was due and the payment went to his son as owner of the property. Nevertheless the majority of the Court held in favor of the commissioner, and much of the language in Mr. Justice Stone's opinion could justify an extremely broad interpretation. After citing and to some extent discussing *Burnet v. Wells*, *Douglas v. Willcuts*, *Helvering v. Clifford*, and other cases, the Court said:

> Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. *Burnet* v. *Wells*, *supra*.
>
> Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the pay-

[51] Under this rule future earnings cannot be assigned so as to exclude them from the taxable income of the party earning them.

[52] This is not necessarily a criticism. Some doubt as to the exact location of the line between taxability and tax avoidance, like the vague definition of "fraud," may discourage those who habitually cut as close as possible to a known line between the legal and the illegal.

[53] 311 U.S. 112 (1941).

[54] 311 U.S. 122 (1941).

ment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son.[55]

It was true in the *Horst* case and stated in the first paragraph of Mr. Justice Stone's opinion that the interest coupons were detached from the bonds, delivered to the donee, and paid at maturity all within the same year. However, *Helvering v. Eubank* involved a life insurance agent who in 1924 and in 1928 made voluntary assignments of his future right to collect renewal commissions on insurance already sold by him, no further act being necessary by the assignor to secure the right to these commissions. The Court held that renewal commissions paid to the assignees in 1933 constituted part of the assignor's taxable income for that year, saying, "this is a companion case to *Helvering v. Horst* .... and presents issues not distinguishable from those in that case."[56]

The cases of *Helvering v. Horst*, *Helvering v. Eubank*, *Helvering v. Clifford*, and *Burnet v. Wells*, taken together, justify a rule totally destroying the income tax advantages of any family trust by taxing all trust income to the settlor as long as he lives. In determining either to whom the income should be paid or whether it should be accumulated, every trust involves "a continuing exercise by the settlor of a power to direct the application of the income along pre-determined channels." In every such case the donor, by the creation of the trust, may have precluded any possibility of collecting the trust income himself but "nevertheless, by his act, procured payment of the interest as a valuable gift to a member of his family," and thus used his right to receive income "to procure a satisfaction which can be obtained only by the expenditure of money or property." If the existence of Sections 161–67 does not operate, even by interpretation, to narrow the scope of Section 22 as applied to trust income there is no obvious place to draw the line short of taxing the income of all family trusts to the settlor during his life.

What are the warnings which should be drawn for one who is supervising the disposal of property today? Obviously the draftsman of a trust is walking on quicksand and it is no guarantee of a satisfactory future that an instrument drawn today is within the actual holding of cases already decided. At the very least a settlor should wholly and completely surrender control, saving to himself no reversionary interest or possibility of reverter, no power to alter or amend, no hope of enjoyment, nor even the non-beneficial but practically useful control of a trustee. Even though all this is done no one can safely guarantee that the trust will result in tax savings in the future. It might even result in the aggravation of tax bur-

[55] Helvering v. Horst, 311 U.S. 112, 116–17 (1941).

[56] Helvering v. Eubank, 311 U.S. 122, 124 (1941).

dens. Quite apart from the possible activities of Congress, the cases of the last few years indicate a real possibility that the income of all family trusts may in the near future be held taxable to the grantor during his lifetime. A less radical step in judicial legislation would be to tax to the grantor the income of all trusts for accumulation, on the ground that here we have the clearest instance of the "direction of the application of income along predetermined channels."[57] But it is hard to say why the *Horst* and *Eubank* cases do not justify taxation to the grantor even where the income is currently distributed to the beneficiaries. It may be objected, and probably with reason, that the Court could not go quite this far since such action in every case would constitute not merely a judicial addition to Section 22 but judicial repeal of Section 161.[58] However, the existence of Section 161 did not prevent the result of the *Clifford* case and the Court there deliberately refrained from putting any definite limitation on the scope of its decision.

In the estate tax field Congress has already gone a trifle farther than under the income tax in disregarding inter vivos trusts in the computation of taxable estates. However, there is nothing to prevent the Court from reconsidering *United States v. Wells* and coming to the conclusion that all transfers in trust which serve substantially the same purposes as testamentary dispositions (although they may have other motivations as well) should be treated as transfers "in contemplation of death." Moreover, there are two simple changes which Congress might make in the present laws largely to destroy both the income tax and estate tax advantages of inter vivos trusts as against outright gifts or testamentary disposition. One of these would be to apply a prohibitive rate of income tax to the accumulated income of trusts; the other would be to combine the present estate and gift taxes in a single tax on gratuitous transfers or receipts.[59]

What then does wisdom counsel in the creation of trusts today? The only wise advice today is to create no trusts unless two or three years' income tax savings and the chance, far from guaranteed, of further savings at the settlor's death are regarded as worth any disadvantages which might follow from the establishment of irreversible property settlements to tie the hands of the donor in the future.

[57] A line drawn at this point would make practical good sense. It is only as to accumulated income that the trust offers substantial income tax advantage over outright gifts of capital. So long as reduction of family income is permitted by division of capital among the members, there is no obvious reason for penalizing trusts as against outright transfers save in the case where the grantor has attempted to preserve the substance of his wealth while transferring the tax liability to another. See the discussion at pages 430–31 supra.

[58] Note 49 supra.

[59] See James, Irascible Comments on the Revenue Laws, 9 Univ. Chi. L. Rev. 58 (1941).